

**RELATIONSHIP BETWEEN INTERNAL
SHARIAH AUDIT CHARACTERISTICS AND ITS
EFFECTIVENESS, ROLE OF SHARIAH
SUPERVISORY BOARD AS A MODERATOR IN
ISLAMIC FINANCIAL INSTITUTIONS IN
BAHRAIN**

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UNIVERSITI SAINS MALAYSIA

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BAHRAIN**

by

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ACCA	Association of Certified Chartered Accountant
ACSAA	Association of Chartered Shariah Accountants and Auditors
AGC	Audit and Governance Committee
AIS	Accounting Information System
ASIFI	Auditing Standard for Islamic Financial Institutions
AVE	Average Variance Extracted
BisB	Bahrain Islamic Bank
BNM	Bank Negara Malaysia
BOD	Board of Director
CB	Covariance Based
CBB	Central Bank of Bahrain
CEO	Chief Executive Officer
CIA	Certified of Internal Auditor
CIBAFI	General Council for Islamic Banking and Financial Institutions
CIPA	Certified Islamic Professional Accountant
CPA	Certified Public Accountants
CR	Composite Reliability
CSAA	Certified Shariah Advisor and Auditor
CSR	Corporate Social Responsibility
DFR	Department of Fatwa and Research
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GDP	Growth Domestic Product

GSIFI	Governance Standard for Islamic Financial Institutions
IAIB	International Association of Islamic Banks
IAs	International Accounting Standards
IBs	Islamic Banks
IDB	Islamic Development Bank
IFI	Islamic Financial Institution
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IIA	Institute of Internal Audit
IIFM	International Islamic Financial Market
IIRA	Islamic International Rating Agency
IMF	International Monetary Fund
INTOSIA	International Organization for Supreme Audit Institutions
IPPF	International Standards for Professional Practice Framework
ISA	Internal Shariah Auditor
ISPPIA	International Standard for the Professional and Practice of Internal Auditing
ISRA	Islamic Shariah Research Academy
LMC	Liquidity Management Centre
MIA	Malaysian Institute of Accountants
MIFC	Malaysian International Financial Centre
NSAC	National Shariah Advisory Council
PLS	Partial Least Square
SAs	Shariah Advisors
SEM	Structural Equation Model

SGF	Shariah Governance Framework
SSB	Shariah Supervisory Board

**HUBUNGAN DI ANTARA CIRI-CIRI AUDIT DALAMAN SHARIAH DAN
KEBERKESANANNYA, PERANAN OLEH LEMBAGA PENYELIAAN
SHARIAH SEBAGAI PENYEDERHANAAN DALAM INSTITUSI KEWANGAN
ISLAM DI BAHRAIN**

ABSTRAK

Audit Syariah dikendalikan oleh ketua jabatan audit dalaman di Institut Kewangan Islam (IFI) yang mempunyai pengetahuan dan kemahiran yang cekap terhadap Syariah. Kebanyakan daripada profesional tidak mempunyai waktu yang mencukupi untuk menimba pengalaman bagi memberi nasihat atau kecekapan dalam menguruskan transaksi IFI. Pengalaman juruaudit Syariah dalaman sukar didapati di dalam beberapa IFI. Mempunyai kekurangan pengukur untuk mengaudit prestasi IFI keatas hubungan bagi merealisasikan Maqasid al-Shariah serta tidak mempunyai ciri-ciri audit Syariah dalaman akan menjurus kepada ketidakberkesanan audit Syariah dalaman di dalam IFI. Fenomena ini akan memberi kesan kepada tahap keberkesanan terhadap audit Syariah dalaman di dalam IFI. Objektif utama kajian ini adalah untuk mengkaji hubungan diantara ciri-ciri audit Syariah dalaman (kebebasan, kompetensi, dan prestasi kerja audit dalaman Syariah) dan keberkesanan audit Syariah dalaman di dalam IFI di Bahrain. Tambahan pula, kajian ini menyiasat peranan lembaga penyeliaan Syariah sebagai kesan penyerderhanaan dalam perhubungan di antara ciri-ciri audit Syariah dalaman dan keberkesanan. Dengan itu, Kajian daripada 52 ketua jabatan audit dalaman Syariah IFI yang berdaftar di bawah Bank Pusat di Bahrain. Kajian ini menganalisis data dengan menggunakan Pendekatan Kuasa Dua Terkecil Separa melalui SmartPLS. Kajian menunjukkan bahawa kompetensi audit Syariah dalaman dan prestasi kerja Syariah dalaman adalah perkaitan yang positif dengan keberkesanan audit Syariah dalaman. Dua pembolehubah; kebebasan oleh audit Syariah dalaman dan lembaga penyelia Syariah

mempunyai perkaitan positif keatas kecekapan audit Syariah dalaman, tetapi sumbangannya kepada kecekapan keberkesanan audit Syariah dalaman tidak signifikan. Walau bagaimanapun, kesemua peramal dan penyerderhanaan menyumbang sebanyak 63.2% terhadap sumbangan keberkesanan audit Syariah dalaman di dalam IFI. Oleh itu, kajian ini percaya bahawa ia dapat memberi manfaat kepada kesemua IFI dalam meningkatkan keberkesanan audit Syariah dengan melabur di dalam pendidikan dan latihan secara berterusan bagi mengekalkan kecekapan teknikal jabatan audit Syariah dalaman dan menghantar audit Syariah dalaman untuk mendapatkan kelayakan professional yang dijalankan oleh AAOIFI.

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INSTITUTIONS IN BAHRAIN**

ABSTRACT

Shariah audit is performed by Head of internal audit department of Islamic financial institutions (IFIs) who is supposedly having adequate Shariah related knowledge and skills. Many professionals have not had enough time to gain the required experience to enable them to competently advise on or manage IFI transactions. The internal Shariah auditor experience is relatively scarce in some IFIs. The lack of measurement to audit the performance of IFIs in relation to the realization of Maqasid al-Shariah as well as the absence of internal Shariah audit characteristics will lead to ineffectiveness of internal Shariah auditors in the IFIs. This phenomenon will affect the effectiveness of internal Shariah auditors in the IFIs. The main objective of this study is to examine the relationship between internal Shariah audit characteristics (independence; competency and work performance of internal Shariah audit) and its effectiveness in IFIs in Bahrain. In addition, the study also investigates the role of Shariah supervisory board as a moderating effect in the relationship between internal Shariah audit characteristics and its effectiveness. The study surveys Head of internal Shariah audit department of 52 IFIs registered under central bank of Bahrain. The data were analyzed using structural equation method via SmartPLS. The study revealed that the competency of the internal Shariah audit and work performance of internal Shariah was positively associated with internal Shariah audit effectiveness. The remaining two variables; internal Shariah audit independence and Shariah supervisory board were found to be

positively related to internal Shariah audit effectiveness, but their contribution to the internal Shariah audit effectiveness were statistically not significant. However, all the predictors and moderator accounts for 63.2% of the contributions for internal Shariah audit effectiveness in the IFIs. Hence, it is believed that this study well benefits to all IFIs in improving their internal Shariah audit effectiveness by invests in continuing education and training to maintain technical competence of internal Shariah audit department and sending internal Shariah audit to get professional qualifications that conducted by AAOIFI.

CHAPTER 1

INTRODUCTION

1.1 Introduction

This chapter introduces the research agenda of this study. It outlines the background of the study, problem statement, research questions, research objectives, significance of the research, definition of key terms, and organization of the remaining chapters.

1.2 Background of the Study

The Shariah audit function is performed by internal auditors who have adequate Shariah related knowledge and skills. It is handled by the internal audit department of Islamic financial institutions (IFIs) and they should be able to demonstrate that there is no threat to its independence such that an outsider would not doubt the auditor's objectivity (Shafii, Salleh, Hanefah, & Jusoff, 2013). Their essential goal is to ensure a sound and effective internal control system which is in compliance with the Shariah rules and principles (Yaacob, 2012). Shariah audit is an examination of the extent of IFIs compliance, in all its activities, with the Shariah rules and procedures.

This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of associations, financial statements, reports (especially internal audit and central banks inspection), circulars, etc. (AAOIFI, 2010). Shariah auditing has gained importance over the recent years as there is a growing awareness among the IFIs that every such institution should contribute towards achieving the objectives of Islamic law- the Maqasid al- Shariah (Shahul & Yaya, 2005). The

objectives of a Shariah audit is to ensure that the activities carried out by an IFI do not contravene the Shariah.

IFIs that offers Islamic financial services are expected to operate with reference to the code of Islamic ethics and must function within the limits of the Shariah. Thus, in order to ensure that the operations of IFIs do not contradict the Shariah rules and principles, the Shariah Supervisory Board (SSB) normally functions as advisors or supervisors of IFIs activities. These activities are intended both to enhance the confidence of the users of the financial statements of IFIs regarding the information that is produced by them and to encourage these users invest or deposit their funds in IFIs and to use their services.

According to AAOIFI (2010) the internal Shariah audit shall be carried out by an independent division/department or part of the internal audit department, depending on the size of an IFI. It shall be established within an IFI to examine and evaluates the extent of compliance with the Islamic Shariah rules and principles, Fatwas, guidelines, and instructions issued by the IFIs SSB, hereafter referred to as Shariah rules and principles. The primary objective of the internal Shariah audit is to ensure that IFI discharges its responsibilities in relation to the implementation of the Shariah rules and principles determined by the IFI's SSB. The internal Shariah audit is an integral part of the Shariah governance of the IFI and operates under the policies established by the IFI. It shall have a stated purpose, authority, and responsibility (charter). The charter shall be prepared by management and shall be consistent with the Islamic Shariah rules and principles. The charter shall be approved by the SSB of the IFI and issued by the board of directors.

The internal Shariah audit will first plan each review assignment and the documentation, then they will collect, analyse, and interpret all matters related to the review objectives and scope of work, including the examination documentation, analytical review, inquiries, discussions with management, and observations to support their review results (Roszaini, 2010).

The responsibility of internal auditor has recently been extended to include consultancy and assisting in corporate governance (Stewart & Subramaniam, 2010). The role has also been expanded to include Shariah audit in ensuring that the operations of IFIs are Shariah compliant. This leads to the issues of independence and objectivity, competency of the internal auditor and auditor's performance in performing new task, which has been outlined in AAOIFI standards. The role of an auditor in the Islamic economy is very different as they are responsible to the society and help uphold the Islamic principles. The role of conventional auditors in Islamic practices has been widely criticized by many Muslims scholars. As Khan (1985) argued that the role of conventional auditors in the capitalist framework is solely answerable, and to provide assurance and attestation to the management and shareholders of the company particularly on financial matters. The importance of internal Shariah audit in an IFI setting, especially in Islamic banks leads various researchers to be concerned over its operation. An organization that has an effective internal audit function will be much better than those organizations that has no such a function, especially in relation to fraud, detection and prevention (Corama, 2006; Maria, 2012; Omar & Bakar, 2012).

Al-Twajry, Brierley, and Gwilliam (2003), indicates that, the importance of having an effective internal audit, is to ensure the achievement of organizational objectives. The concept of effectiveness has received increasing attention in the literature in recent times. Internal auditors assist management in ensuring that there is a proper internal control system in place and that the operations of the company are carried out efficiently, economically and effectively (Haron, Chambers, Ramsi, & Ismail, 2004). Internal Shariah audit effectiveness helps in promoting the work of an Islamic bank because the financial reports reflect the internal Shariah audit department's quality. The internal Shariah audit department is regarded as the key element in the application of accounting systems in Islamic banks and it helps in evaluating the work of the department. The internal Shariah audit is considered as the backbone of the business accounting as it is the section that records all businesses related to the sector. It is concerned with advising entities on how to achieve their objectives through managing risks and improving internal control. Even though the internal Shariah audit is useful in all types of IFIs, much of it is required in the public sector where objectives are usually broad, complex and not easy to measure.

In recent years, internal auditing has assumed a strategic dimension and has become an essential component of public sector governance and financial management reforms in many developing countries (Arena & Azzone, 2009; Diamond, 2002; Haron et al., 2004). Audit is said to bring forth accountability, accountability brings forth control and control inevitably brings the power for governance (Normanton, 1966). Audit whether external or internal is very useful in improving the financial and operational performance of entities by virtue of its remedial and deterrent capabilities.

In Bahrain, a country in which Islamic banks are well-established, Shariah auditing and Islamic accounting are relatively new. Bahrain is considered as the primary financial market in Gulf countries, for both Islamic and non-Islamic financial institutions (Hood & Bucheery, 1999). Researches concerning the Kingdom of Bahrain market have been ignored for decades in the past, particularly because of the restrictions imposed in the foreign stock ownership, the lack of common accounting and auditing regulations, and the uncertainty of economic and political conditions (Al-Shammari, Brown, & Tarca, 2008). However, the Kingdom of Bahrain has recently implemented a large number of strategies and policies that transfer them to the market-orientation economy (Aljaaidi & Abidin, 2010). Consequently, local, regional, and foreign investors have found the Gulf region as a profitable business environment for their projects. In the light of the rapid shift and growth in the economic development of the Kingdom of Bahrain, an increased demand has been placed for the auditing services in a way that financial information provided by companies must be assured by auditors (Aljaaidi & Abidin, 2010).

However, the extent of the contribution that internal audit function can offer any entity depends on how effectively it operates in the management of the entity concerned (Dittenhofer, 2001; Mihret & Yismaw, 2007). While the concept takes a centre stage in the improvement efforts of many countries, others have yet to experience such service. Internal Shariah auditors within the IFIs assist to review the activities of Islamic banks operation with the aim of ensuring that the activities carried out are Shariah compliant. Shariah compliant refers to the products and services produced or offered by an IFI in accordance with Shariah rules and principles. Examples of Shariah compliant include: inception and conceptualization

of Islamic instrument, structuring the product according to Shariah, legal documentation, execution and implementation of Islamic instrument, audit and review, restructuring (if needed) and recovery mechanisms and dispute resolution (Adawiah, 2007).

Therefore, maintaining an effective internal Shariah audit is very critical to management. AAOIFI emphasizes on the internal Shariah audit independence, competence and performance of audit work in enhancing its effectiveness. AAOIFI requires the head of internal Shariah audit to report directly to SSB and internal Shariah audit function should be performed impartially, professionally and with due professional care in order to support internal Shariah audit independence and competence. The internal Shariah audit's work is influenced by SSB as it supports the work of internal Shariah audit and ensure that it maintains its quality in carrying out its task (Al-Mahmoud, 2007). However, there is no previous study in IFIs in terms of the effectiveness of the internal Shariah audit. Internal Shariah audits are needed because the current internal audits do not intend to provide a reasonable assurance that their Islamic banking activities are Shariah compliant. Therefore, this study wishes to examine the relationship of internal Shariah audit's characteristic (independence, competence and work performance of internal Shariah audit in engagement planning, performing the engagement and communicating results) and its effectiveness. In addition, the study examines whether the role of SSB will have a positive influence on the relationship.

1.3 Problem Statement

This study investigates the effectiveness of internal Shariah audit in Islamic financial institutions (IFIs) in Bahrain. A review of the literature indicates that there is a lack of extensive research in this area. The studies that are available tend to be limited in scope of needs and challenges, professionalization, conceptualizing the duties and roles of Shariah auditors as well as Shariah audit practices in IFIs focused on the competency, independence, scope and work performed by Shariah auditor. The main issue of this study is to examine the relationship between internal Shariah audit characteristics and its effectiveness: a moderating effect of the role of Shariah supervisory board in IFIs in Bahrain.

The rapid growth of IFIs meant that the industry has not been able to produce enough experts needed to support this growth (Iqbal & Molyneux, 2005). Many professionals have not had enough time to gain the required experience to enable them to competently advise on or manage IFI transactions. The Internal Shariah auditor experience is relatively scarce in some IFIs. This phenomenon will affect the effectiveness of internal Shariah auditors in the IFIs. To address this issue in the number of trained professional auditors in IFIs, AAOIFI has offered training leading to the Certified Shariah Advisor and Auditor (CSAA) and Certified Islamic Professional Accountant (CIPA) qualification. In fact, it's a positive initiative, but there are no pre-requisites required for the enrollment in the courses. The targeted candidates are those who are currently involved with Shariah compliance and review for banking and finance, professional and executives who are currently involved in accounting, auditing and finance and professional and executives with interests in the field of Shariah, accounting, auditing or finance (Othman, Ameer, & Choudhury,

2015). This implies that any interested person can apply irrespective of his background which will affect the desire object of the whole programme since there is no any stated requirement mandating the applicant to possess before application for enrollment.

Consequently, the qualifications will not cover the full AAOIFI standards leading to the question of how many internal Shariah auditors in IFIs will truly qualify. Thus, the Shariah department will unavoidably be under-resourced, and it is most regrettable if management treats it as low priority (Rehman, 2012). This is due to fact that its role is very fundamental to the existence of the IFI. In recognition of these challenges, this study intends to examine the effectiveness of internal Shariah audit in IFIs in Bahrain which cannot be achieved without requiring qualifications as well the independence, competency and work performance.

Generally, there are two types of Shariah compliance: (i) ex-ante compliance and (ii) ex-post compliance. Ex-ante Shariah compliance is basically the SSB is directing, reviewing and supervising the activities of the IFIs in order to ensure that they are in compliance with the Islamic Shariah rules and principles. These activities include ensuring that the IFI comply with Shariah rules and guidelines during the design of contracts and agreements, during the process of transactions, during the conclusion and execution of the contract, and up to implementation of the terms of contract and liquidating. So far, very few IFIs undertake ex-post Shariah compliance processes (Rahman, 2011).

Ex-post Shariah compliance processes requires thorough and comprehensive internal Shariah audits in order to review and check the transactions that took place after the execution of the contracts. The ex-post Shariah compliance is to perform the random samples of completed transactions to ensure that these transactions conform to Shariah rules and principles. An internal auditor may require performing this were the result of the audit needs to be reported to management (Rahman, 2008). However, the limitation in ex-post Shariah compliance will create a vacuum with resultant low work performance.

The problem of internal Shariah audit in Bahrain indicates a lack of internal Shariah audit effectiveness. Even though the SSBs of IFIs have expressed their opinions on Shariah compliance, thorough internal Shariah audits or review processes of Shariah legal contracts, documentations and operations are scarce and poorly conducted (Rahman, 2008). In the same manner the ineffectiveness of internal Shariah audit may be blamed on the lack of internal Shariah audit characteristics which are measured by previous researchers, namely: independence, competence and work performed in engagement planning, performing engagement and communicating results (Ahmad, Othman, Othman, & Jusoff, 2009; Al-Twajjry et al., 2003; Alzeban & Gwilliam, 2014; Arena & Azzone, 2009; Getie Mihret & Wondim Yismaw, 2007). The absence of these characteristics of the internal Shariah audit to perform an effective internal Shariah audit in IFIs were demonstrated by SSB's reports for the past five years from annual reports of IFIs available on the website from 2010-2014, found three SSB's reports that are not complying with Shariah Law. See table 1.1 below shows in details the reason for non-Shariah compliant.

Table 1.1 Types of Non-Shariah compliance perpetrated by IFIs

No.	Bank Name	Financial Year	Non-Shariah Compliance	Types of Reports
1	Ithmaar Bank	2010-2014	Conventional assets and liabilities. Interests and Impermissible earnings which has been calculated in financial year 2010 at negative 1.55 cents per share. In 2011 it was 0.28 cents per share, in 2012 it was 2.8 fils per share, in 2013 it was 4.36 per share and 1.13 US cents per share in 2014. Gains made from sources prohibited by Shariah were evaded and transferred to charity fund. All the amounts collected as customers' donations and commitments on late payment were posted to the charity fund.	Violated Islamic Shariah rules and principles or Fatwa.
2	Ibdar bank	2013	Impure earning equivalent to USD 9,356 were identified. The SSB is directed management to disburse this amount for charity purposes immediately.	Violated Islamic Shariah rules and principles or Fatwa.
3	Seera Investment Bank	2013	The bank renewed a conventional finance facility.	Violated Islamic Shariah rules and principles or Fatwa.

As shown in Table 1.1 above, the internal Shariah audit in IFIs is not able to detect the non-Shariah compliance that occurred in IFIs, especially in the case of Islamic banks. This non-Shariah compliance can affect the income and profitability of banks adversely. In the long-run, mitigation of Shariah principles can negatively affect the perception of shareholders about the Islamic financial practice by causing a serious loss of trust and credibility. As most the clients use Islamic banks for religious reasons, non-Shariah compliance can be a reason for reputation risk that can make the Islamic finance sector susceptible to instability and trigger failure (Qattan, 2003).

The Table 1.2 below shows the size of IFIs based on assets, profitability and return on assets of financial year 2014. The three Non-Shariah compliance, banks reported recently constitute 60% of the Bahraini Islamic banking industry in terms of market capitalization or size of the market.

Table1.2 IFIs based on Total assets, Profitability and Return on Assets

No.	IFIs Name	Total Assets (\$)	Profit/Loss (\$)	ROA (%)
1	Al Baraka Islamic Bank	23,463,589	274767	1.17
2	Al-Salam Bank	5,178,505	41901	0.81
3	Bahrain Islamic Bank	2,317,942	24623	1.06
4	Itmaar Bank	7,860,904	-8847	-0.11
5	Khaleeji Commercial Bank	1,436,101	-50874	-3.54
6	Kuwait Finance House	3,925,119	13552	0.35
7	ABC Islamic Bank	1,001,744	12217	1.22
8	Arab Islamic Bank	29356000	318000	1.08
9	Bank al-Khair	564,983	-17316	-3.06
10	Citi Islamic Investment Bank	16,567,000	3658	0.02
11	First Energy Bank	1417293	40088	2.83
12	GFH Financial Group	907853	6267	0.69
13	Ibdar Bank	360,060,444	22575	0.01
14	International Investment Bank	271423	-8125	-2.99
15	Investment Dar Bank	105992815	-10548395	-9.95
16	Investors Bank	38782073	-1733640	-4.47
17	Liquidity Management Centre	202003	4224	2.09
18	RA Bahrain	57521	10126	17.60
19	Seera Investment Bank	310,627	4100	1.32
20	Turkiye Finans Katilim Bankasi	11139130	135280	1.21
21	Venture Capital Bank	249402	14589	5.85

Source: IFIs annual reports (2014)

Non-Shariah compliance is a significant risk for an IFI from two perspectives: firstly, it affects the reputation of IFIs and deteriorates the reliance of the depositors, investors, customers and other stakeholders in the long term. Secondly, it will have an impact on the revenue as well, because in case of an identified Non-Shariah compliance, the income arising from non-Shariah compliance is to be given to charity. Since Shariah compliance is the essence of Islamic bank's activities, it is thus crucial that a governance mechanism is in place to ensure the credibility and viability of the IFIs are expected to adhere to the Islamic Shariah principles such as

prohibition of receipt and payment of Riba (Interest), engage in Gharar (uncertainty includes gambling), pay Zakat dues, and avoid engaging in non Islamic business (such as the sale of alcohol, gambling, casino activates, pork production and pornographic production).

The internal Shariah audit is required to ensure that the activities carried out by an IFI do not contravene the Shariah rules and principles and the management of an IFI discharges their responsibilities in relation to the implementation as determined by the IFI's SSB. An Internal Shariah audit is required also to add value and improve IFI compliance by providing an independent assessment and objective assurance. Previous researchers have found that independence, competence and work performance of internal audit have an influence on their effectiveness (Al-Twaijry et al., 2003; Alzeban, 2014; Getie Mihret & Wondim Yismaw, 2007).

By designing the program of the internal Shariah audit based on the defined scope of work of internal Shariah audit procedures for a complete Shariah audit, are put in place. Consequently, conducting the Shariah audit in accordance with the defined scope of internal Shariah auditing in particular is concerned with work that would enhance the effectiveness of the internal Shariah auditor. Therefore, no internal Shariah auditor can be effective unless the internal auditor is independent (Kasim, 2009; Rahman, 2011; Shafii et al., 2014), competent (Nawal, Ibrahim, & Sulaiman, 2009; Yaacob & Donglah, 2012) and have a good work performance (Hameed, S. & Mulyany, 2009; Kasim & Sanusi, 2013).

Studies have also shown that an effective oversight board is an important factor that will influence the effectiveness of internal audit (Getie Mihret & Wondim Yismaw, 2007; Hanim, Haron, & Jantan, 2005; Turley & Zaman, 2007). However, it will be important to empirically examine the moderating effect of SSB in future studies (Puad, 2014; Sharma, Sharma, & Ananthanarayanan, 2011). In this study, SSB plays an important supervision to ensure that internal Shariah audit is carrying out their role effectively. Uniquely, Shariah audit in the IFIs is supervised by the SSB (Kasim, 2009). Currently, SSB acts as Shariah auditors who endorse Shariah reports to users of financial statements regarding the Shariah matters in IFIs (Karim, 1990).

According to AAOIFI (2010), the SSB is entrusted with the duty of directing, reviewing, and supervising the activities of IFIs in order to ensure that they comply with Shariah rules and principles, the Fatwa and rulings of the SSB shall be binding on the IFI. The SSB also has to assess further information and reports such as circulars, operating and financial reports and policies. In addition, if the Shariah audit function does not exist the SSB can direct the management to get the people to perform the function and, supervise the daily dealings and report directly to them about any transactions that do not comply with the Shariah rules and principles (Al-Mahmoud, 2007).

Hence, without a strong and proper internal Shariah auditor, the SSB would not be able to support their opinions as expected by the stakeholders. Turley and Zaman (2007), argue that an audit committee is able to set a tone that allows internal audit to have a specific degree of influence in the organization. As such, SSB is seen to play a critical role in supporting the internal Shariah auditor's position and strengthening

internal Shariah audit effectiveness. Successively, SSB significantly relies on internal Shariah audit to perform its duties. On the other hand, internal Shariah auditors can assist external auditors to understand the role and work performed by internal Shariah auditors. Selecting a sample to be tested and sending confirmation letters to the debtors and the banks are other areas where internal Shariah auditors can be of assistance to the external auditors. External auditor also reviews the findings of all internal Shariah audit. Consideration shall be given to the findings of these reviews and whether these findings affect the nature, timing or extent of the work carried out by the external auditor during his examination (AAOIFI, 2010).

Followings models show the reports of internal Shariah auditors in IFIs, the roles of internal Shariah audit are two prongs as he serves Audit and Governance Committee (AGC) can be considered similar to audit committee and SSB issues the audit reports to shareholders- on Shariah compliant matters, as well as serves Chief executive officer (CEO) on a daily basis transaction. Partly based on internal Shariah auditors (ISA) findings and SSB's own investigation. Figure 1.1 shows the relationship between SSB and AGC in IFIs in Bahrain.

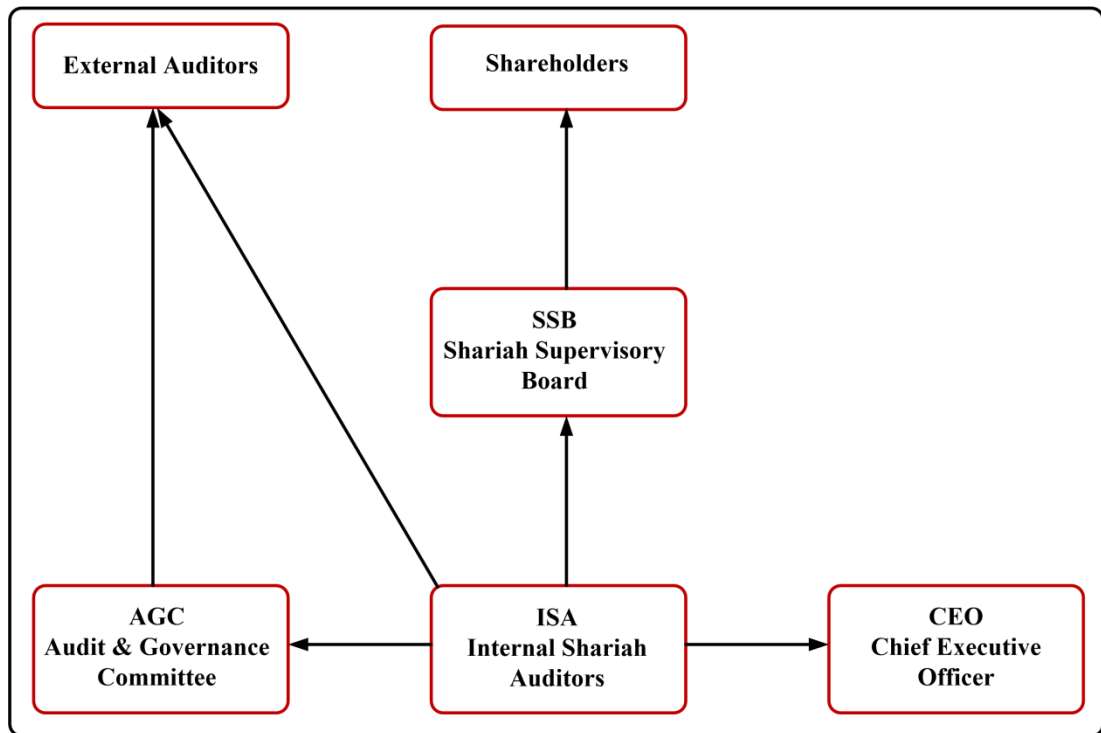


Figure1.1 Report of Internal Shariah Auditor in IFIs

Cooperation between internal Shariah auditor and external auditors has long been seen as important to the audit benefits for the IFIs and external stakeholders. Academic studies indicate that appropriate cooperation increases the economy, efficiency, and effectiveness of audit and helps management provide a high quality service. Therefore, the absence of cooperation between internal and external auditors is frequently identified as a factor impairing the quality of both forms of audit in the public sector in developing countries (Brierley, J., El-Nafabi, & Gwilliam, 2003; Brierley, J. A., El-Nafabi, & Gwilliam, 2001). Figure 1.2 shows the relationship between external, internal Shariah auditors, and SSB:



Figure1.2 Relationship between Internal, External Auditor and SSB

However, to the best of the researchers' knowledge, there is no previous research that has examined the relationship between internal Shariah audit characteristics, namely (independence, competence and work performances of internal Shariah audit in terms of engagement planning, performing engagement and communicating results of the internal Shariah audit), and its effectiveness and role of SSB as a moderator in IFIs in Bahrain.

1.4 Research Questions

Given the problem statement described in the previous section, this study aims to investigate the relationship between internal Shariah audit characteristics, namely: (internal Shariah audit independence, internal Shariah audit competence and work performance of internal Shariah audit in engagement planning, performing planning and communicating results), and its effectiveness role of SSB as a moderator. The study hopes to answer the following research questions as follows:

1. What is the relationship between internal Shariah audit independence and internal Shariah audit effectiveness in IFIs in Bahrain?
2. What is the relationship between internal Shariah audit competence and internal Shariah audit effectiveness?
3. What is the relationship between work performance of internal Shariah audit and internal Shariah audit effectiveness?
4. Does the role of SSB moderate the relationships between internal Shariah audit characteristics (Independence; competence and work performance of internal audit) and its effectiveness?

1.5 Research Objectives

The principal aim of this study is to examine the relationship between internal Shariah audit characteristics and its effectiveness in IFIs in Bahrain. Therefore, the research objectives of this study are:

1. To examine the relationship between internal Shariah audit independence and internal Shariah audit effectiveness in IFIs in Bahrain.
2. To examine the relationship between internal Shariah audit competence and internal Shariah audit effectiveness.
3. To determine the relationship between work performance of internal Shariah audit in engagement planning, performing engagement and communicating results and internal Shariah audit effectiveness
4. To determine whether the role of SSB moderates the relationship between internal Shariah audit characteristics (independence; competence and work performance of internal Shariah audit) and its effectiveness.

1.6 Significance of the Study

This study contributes to the theoretical, methodological and the practice of the internal Shariah audit profession in IFIs in Bahrain. From the practical perspective, obviously, empirical studies on internal Shariah audit effectiveness are not yet study in IFIs in Bahrain. Therefore, the studies on conventional banks and companies were used as the guidance in evaluating and improving internal Shariah audit effectiveness. This study provided empirical evidence on the relationship between internal Shariah audit characteristics and it is effectiveness. It was accompanied by a moderating effect of the role Shariah supervisory board quality within the context of IFIs in Bahrain. The study may also benefit policy makers within Bahrain especially

when they consider the roles of those variables in the study toward objective achievement of an IFI.

The findings from this study may enable researchers, scholars and internal Shariah auditors, to understand how the salient Maqasid Al Shariah theory can be applied as the basis for a theoretical framework of this study. This theoretical framework was developed to provide more insight on the contributing factors that will affect internal Shariah audit effectiveness. Consequently, this study will contribute to the body of literature by extending the needs for more empirical internal Shariah audit researches in the future.

This study adds to the growing body of international literature concern with the relation between various corporate Shariah governance mechanisms, namely SSB, AGC and internal Shariah audit. A significant amount of academic research has been examining the contributing factors that affect internal audit contribution in a financial statement audit in companies and public sector organizations, the results of these studies are inconsistent and the only direct relationship tested. There are no studies that examine the relationship between internal Shariah audit characteristics, SSB and internal Shariah audit effectiveness in IFIs in Bahrain. Thus, this is the first type of research conducted in IFIs in Bahrain. Therefore, from a practical perspective, this study provides feedback to the regulators, e.g. AAOIFI and IFSB on the need for Shariah rules and principles that support and enhance the internal Shariah audit in an IFI and the relationship between the SSB and the internal Shariah audit.

Moreover, the methodological contribution of this study is to develop new measurement for internal Shariah audit characteristics, SSB and internal Shariah audit effectiveness based on AAOIFI standards. This study also addresses the research questions by conducting research based on Non-structured interviews with Heads of internal Shariah audit and SSB. The results of this study help to shed light and improve the internal Shariah audit practices and performance in IFIs in Bahrain. The findings of this study will benefit for the academic researchers to rethink on reviewing the syllabus on auditing courses. Finally, this research will be useful to internal Shariah auditor practitioners, members of SSB, AGC, board of directors, shareholders and academic researchers.

1.7 Definition of Key Terms

For the purpose of this study, the following terms will be utilized:

1. Shariah: literally means, “The road to the watering place” or “the straight path to be followed”, and it is often equated with the Islamic law (Choudhury, 2005). Shariah provides a comprehensive guide to the human life and specified the principles which aim to protect the interest of human being. Shariah presents both the social contract and the scientific groundwork for the new global order that is premised on the episteme of Divine unity (Choudhury, 2005). **Holy Qur’an:**

“Then as for he who is given his record in his right hand, He will be judged with an easy account, and return to his people in happiness” (Quran, 84:7-9)

“And indeed, [appointed] over you are keepers, Noble and recording. They know whatever you do” (Quran, 82:10-12).

Sunnah: Prophet Mohammad (p.b.u.h) says: when he has been about IHSAN: “.then tell me about IHSAN: He said: it is to worship Allah as though you are seeing Him, and while you see Him not you truly, He sees you...”

2. Shariah Audit: is an examination of the extent of IFIs compliance, in all its activities, with the Shariah. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of associations, financial statements, reports (especially internal audit and central banks inspection), circulars, etc. (AAOIFI, 2010).
3. Internal Shariah audit: shall be carried out by an independent division/department or part of the internal audit department, depending on the size of an IFI. It shall be established within an IFI to examine and evaluate the extent of compliance with the Islamic Shariah rules and principles, Fatwas, guidelines, and instructions issued by the IFIs SSB, hereafter referred to as Shariah rules and principles (AAOIFI, 2010).
4. Shariah compliance: Is a product or services produced or offered by an IFI in accordance with Shariah rules and principles.
5. Independence of Internal Shariah Audit: Reporting the levels within organization that allow the internal audit department to perform its responsibilities free from interference; avoiding conflict of interests; having direct contact with the board and senior management; having unrestricted access to records, employees and department; having the appointment and removal of the head of internal audit is not under the direct control of executive management; and not performing audit work. (ISPPIA, IIA, 2011).
6. Competence of Internal Shariah Audit: The internal Shariah auditors shall possess the discipline, knowledge and skills, experience essential to the performance of the internal Shariah audit. Proficiency in Islamic Shariah rules and principles in general, and Fiqh al-muamalat in particular, is required in performing internal Shariah audit (AAOIFI, 2010).